

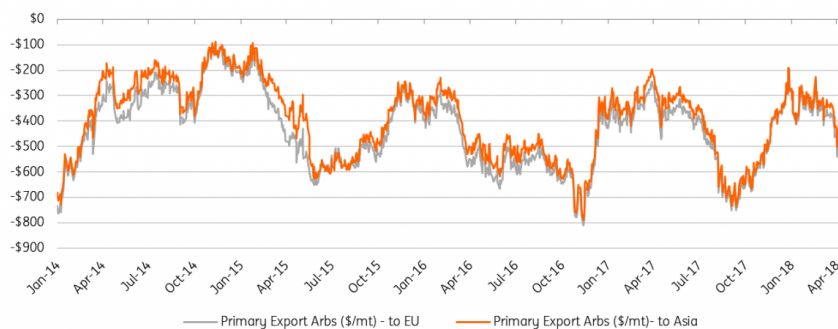
Thinking the unthinkable: Chinese primary metal exports

After briefly hitting highs above \$2,718 on Thursday, the aluminium rally finally hit resistance and paused for breath- and for good reason. The gap between LME and Shanghai is edging ever closer to levels where primary exports are profitable



Source: Shutterstock

Primary aluminium exports from China edging closer to profitability (\$/mt)



Source: LME, SHFE, SMM, Harbor, ING Research

Trade flows to be re-written

As sanctions imposed upon Rusal deter its traditional customers the natural order of aluminium flows stands to be re-written. The rally on the LME these past few weeks and surging regional premiums have far surpassed the moves in Shanghai, so much so that even with China's 15% export tax on primary metal exports, smelters could start to make money by sending primary metal overseas. This is significant. Currently, a 15% export tax makes China a minor exporter of aluminium in primary form, choosing to export instead in the form of semi-fabricated products which earn a 13% VAT rebate. The arb for the Chinese to exporting semis is now hugely profitable (we estimate over \$500/mt when shipping into Asia) and expect semi products will now begin flooding out from China, cannibalising demand for western material and even providing a portion of primary units should the "fake-semi" trade to South Korea and others pick up substantially. ("Fake-semi" is a coil or extrusion with minimal fabrication/alloy so it can be remelted into primary).

Whilst semis exports will be a notable headwind for the new highs in the aluminium price, primary metal flow will be everything. It has always been our conviction that the [LME is thirsty for ingot](#) (only primary metal is deliverable) and resurgent tightness in the spreads are the ultimate upward driver for prices. The tug of war between LME backwardations and ever higher premiums could reach extremes as post-sanction Russian production is walled off from the exchange and western fabricators scramble to replace lost Rusal units (50% in primary form and 50% billets/foundry etc). Backwardations, in turn, drive prices higher by squeezing out shorts (it's costly to roll a short when the market is in backwardation).

It will take a flow of primary metal (from China) [to fill the void](#). If Rusal remains sanctioned, an ex-China market without Russian exports could be looking at astronomical deficits around 5MT (we think some sales will still happen, so likely lower). Chinese semis flow will sure cannibalise much western demand but those fabricators that want to keep on fabricating still demand primary metal. We flagged that [off-warrant stocks are likely to be liquidated](#) amid tight spreads/high premiums but it will not be enough. The next fundamental headwind to higher prices will be the flow of Chinese material and western fabricators will be desperately looking at the high domestic stocks (c.2MT in social warehouses) and spare smelting capacity (c.80% utilisation) for a solution. But with alumina prices through the roof and more charges for captive power, those smelters might require considerably higher Shanghai prices to keep producing a surplus. On the flip side, if Rusal can sell into China this could depress Shanghai prices, boosting the arb wide open without needing much more LME lift. With fundamentals at a crossroads, it's a clearly an appropriate time for these markets to take a breather.